

 INTERNATIONAL CONSULTING CONSORTIUM, INC.

THE PHILIPPINES

CONSULTANCY SERVICES TO BANGKO SENTRAL NG PILIPINAS
ON MICROFINANCE SUPERVISION

(Under contract with Chemonics International Inc.)

January 2005

THE PHILIPPINES: CONSULTANCY SERVICES TO BANGKO SENTRAL NG PILIPINAS ON MICROFINANCE SUPERVISION

Background

In year 2000, the General Banking Law No. 8791 recognized the need to promote the expansion of microfinancing and the Bangko Sentral ng Pilipinas (BSP) has actively supported this initiative by issuing several Circulars that recognize microfinance as a specialized banking service, issuing appropriate regulatory requirements for microfinance operations of banks, and creating incentives for the banking system to go into microfinance. The BSP has also set up a Microfinance Committee that is responsible for internalizing and institutionalizing microfinance examination and supervision procedures within the BSP. The Microfinance Committee is headed by the Deputy Governor of the Supervision and Examination Sector and includes representatives from the Office of the Governor, BSP Institute, Supervisory Reports and Studies, and the Economic Research, Loans and Credit Sectors. The Microfinance Committee:

- Provides the policy framework and overall direction of BSP's microfinance initiatives
- Provides oversight of the microfinance unit in the BSP

In order to properly supervise this growing number of banks involved in microfinance, the BSP's Microfinance Committee has engaged in a continuing effort to monitor and enhance appropriate examination policies and procedures to better measure the institutional risks and performance of the microfinance operations of banks.

Accordingly, BSP created an advisory Microfinance Unit as well as a Microfinance Core Group of examiners that started supervising the activities of rural and thrift banks engaged in microfinance. As of June of 2004, 179 banks are engaged in microfinance operations, six of them on a specialized basis as "Microfinance-Oriented Banks", licensed under a charter created specifically through a BSP regulation. The microfinance portfolio comprises over 542 thousand clients and totals 3.2 billion piso (US\$60 million).

The design of risk-based supervision of banks engaged in microfinance

In 2002, International Consulting Consortium Inc., through a contract with Chemonics International Inc. sponsored by USAID, was assigned the task of developing risk-based examination procedures and to field-test them in coordination with the Microfinance Core Group. In October 2002 and February 2003, an ICC consultant conducted visits to several banks engaged in microfinance, to interview some of its directors, executives, area and branch managers and loan officers, as well as to conduct a review of their financial statements, information systems and operations manuals.

At the end of February 2003, an initial draft of examination procedures to monitor the main risks involved in microfinance and CAMELS indicators for microfinance operations was presented to BSP. After a thorough review by the Microfinance Core Group and the Microfinance Committee, a new draft was produced, which underscored the importance of ensuring that microfinance institutions have reliable information systems to monitor the risk of the microfinance portfolio –thousands of very small, unsecured loans to microentrepreneurs with no financial records- and that management is capable of reacting promptly to situations of increasing risk.

Given the importance of ensuring that banks have implemented adequate loan tracking systems for their microfinance operations, ICC worked during March and April 2003 in developing examination procedures for Information Technology (IT) resources, which were included as an Appendix to the draft procedures and presented to BSP in early May.

During May and June 2003, BSP examiners used the draft microfinance examination procedures to conduct examination in three banks engaged in microfinancing, which allowed for further adjustment and the elaboration of a new final draft. Consultants of ICC monitored these examinations and presented its key findings to the Microfinance Committee.

Initial training on the new examination procedures and CAMELS indicators

In accordance with the implementation plan of the consultancy, the dissemination of the draft microfinance examination procedures and camels indicators was initially conducted in July and August of 2003.

In coordination with the Microfinance Core Group and the BSP Institute, a three-day training seminar was conducted, where 118 rural and thrift bank examiners were presented the following program:

1. A broad review of the microfinance business and the best international risk-management practices, including the implementation of reliable and efficient loan administration systems.
2. The status of the microfinance sector in the Philippines, based on recent Statement of Condition (SOC) reports submitted by rural and thrift banks engaged in microfinance.
3. Lending technologies and risk-management practices currently in place in Philippine microfinance institutions. To this effect, senior managers of banks engaged in group and individual lending were invited to present a summary of their operations and main policies and procedures for loan administration and internal control, including information systems.
4. The key findings of the examinations where the draft examination procedures and camels indicators were field-tested. These were presented by the BSP examiners that participated in the field testing of the examination procedures.
5. A formal presentation and in-depth discussion of the draft examination procedures and CAMELS indicators.

Additionally, at the request of BSP an additional two-day Trainor's Training Seminar was held, with the objective of preparing the eleven staff members of BSP's Microfinance Core Group and some additional examiners from other departments of BSP, to conduct future microfinance examination training of their colleagues from other departments.

In January of 2004, a new series of three seminars was conducted on a similar program, in order to train an additional 119 examiners, including examiners in charge of universal, commercial, thrift and rural banks, as well as officers from the Department of Loans and Credit (in charge of loan rediscount) and from the Supervisory Reports and Studies Office (in charge of drafting regulations, among other duties). Prior to the seminars, the Proposed Amendments were partially adjusted by the consultants in response to the new rules for microfinance risk evaluation established by BSP through Circular 409 of October of 2003, whose provisions were partially based on the findings and suggestions made by the consultants during the previous phases of the consultancy, and in conformity with international best practices. At the request of BSP's Microfinance Core Group, the consultants also reviewed the examination reports and working papers of three examinations conducted in the second semester of 2003.

Also, at this time a one-day workshop with the MABS team was conducted, with the objective of making them aware of the examination objectives and activities and the type of information that will be required from banks engaged in microfinance.

Implementation and further adjustment and training on the new examination procedures and CAMELS

The revised BSP examination procedures for microfinance operations were applied by BSP examiners during 2004, even in the largest (more than 40,000 clients) microfinance-oriented banks. During this period, several issues were raised for review and further adjustment:

- a) Evaluation of internal controls as they relate to the microfinance operations of the banks;
- b) Review of guidelines for validation of the portfolio at risk (PAR) ratio to take into account varying amortization schedules for microfinance loan portfolios;
- c) Review of guidelines for the determination of an appropriate sample size for the verification of microfinance loans;
- d) Review the components of the CAMELS rating and recommend specific numeric weights to take into account microfinance operations of rural and thrift banks;

In January of 2005, an ICC consultant visited BSP to review some reports and working papers of microfinance examinations and discuss the findings with a Working Group organized by the Microfinance Core Group, prior to proceeding with the required adjustments. Three meetings with the Working Group were conducted:

Working Group meetings to coordinate adjustments to examination procedures and CAMELS rating			
Meeting	Date	Topic	Participants*
First	January 4 th	Guidelines for PAR validation under different scenarios	43
Second	January 6 th	Procedures to evaluate internal controls	27
Third	January 11 th	Sampling strategy and CAMELS	32

* From SED IV, the Microfinance Core Group and the Prompt Corrective Action Unit.

A draft version of the adjustments to the examination procedures and CAMELS was duly discussed with the Microfinance Core Group on January 13th and 14th and a final version was prepared for further training of BSP examiners.

On January 18th and 19th, two workshops were conducted to present the adjusted procedures and CAMELS, with the participation of a total of 124 examiners from all supervisory departments:

- ✓ 8 examiners from SED I (universal banks)
- ✓ 11 from SED II (commercial banks)
- ✓ 6 from SED III (thrift banks)
- ✓ 89 from SED IV (rural and microfinance-oriented banks)
- ✓ 9 from DLC (Loans and Credits)
- ✓ 2 from SRSO (Regulation)

The powerpoint presentation for these workshops is attached to this report.

On January 20th, USAID officials were briefed on the process of design, adjustment and training of BSP personnel on supervision of microfinance operations.

On January 21st the final version of the Manual was presented to BSP's Deputy Governor of Supervision and Examination, in coordination with officials from the Microfinance Core Group and the Microfinance Unit. The Microfinance Committee is currently reviewing this version, before its approval by BSP's Board.

Acknowledgements

ICC Inc. and the consulting team in charge of the assignment, wish to express their appreciation to BSP's Microfinance Core Group and its leader Mr. Rogelio Encinas, the Director of SED IV Mr. Wilfredo D'omo Ong, the Microfinance Unit and the COP of the project Mr. John Owens, for their decided support and technical contributions towards the successful culmination of the project.

Supplementary BSP Manual of Bank Examination on Microfinance Operations

Training Workshops

Manila, January 18 & 19, 2005

INTRODUCTION: Microfinance in the Philippines (06.04)

- 179 banks engaged in microfinance operations (6 microfinance-oriented)
- 542,514 borrowers (up to 41.169); P3.2 billion

Content of the Workshop

1. State of microfinance in the Philippines
2. Supplementary Manual on Microfinance
 - Revised formula for Portfolio at Risk (PAR) and detection of irregular loans
 - Procedure to detect unreported refinanced microfinance loans
 - Procedures for evaluating internal control measures
 - Determination of sampling strategy and sample size
 - Proposed amendment to CAMELS for microfinance operations
3. Exercise (MS EXCEL AND MS ACCESS)

Regulation on microfinance loans

- Circular 272
 - P150,000
 - Microenterprise, no financial statements nor BiR
 - Unsecured
 - Lending technology based on cash-flow analysis by bank
 - Daily loan tracking system for delinquency and restructurings
- Circular 409
 - Definition of PAR/past due, restructuring, refinance
 - Allowance for loan losses

Supplementary Manual

- Activity 1: Review of lending policies and procedures
- Activity 2: Data extraction and processing (credit&operational risk, reg. compliance)
- Activity 3: Internal audit
- Activity 4: Internal control
- Activity 5: Information Technology

1. PAR COMPUTATION

- Prerequisites for PAR
 - Inventory of loan products (and/or conditions)
 - For every loan product: formula for determination of date arrears start and computation of days in arrear for every loan
 - Validation of days in arrear computation
- Computation of required reserves and impact on income, net worth and CAR
- Computation of PAR (1,30,60,90)
- OTHER TYPES OF LOANS?

Inventory of loan products and conditions

1. Computation of installment:

- a) fixed principal plus interest
 - b) fixed installment - includes interest
 - c) single payment upon maturity
 - d) irregular amortization schedule
2. Frequency of payments
 3. Grace periods
 4. Payment holidays
 5. Cash collateral – savings component
 6. Simultaneous loans
 7. Variability of interest rates

Formulas for “date arrears start” and “days in arrears”

- Loan product and loan condition specific
- Step by step design
- Adjustments/additions to Data in Soft Copy Required
- Computation of date arrears start and days in arrears

Validation of “days in arrears” computation

- Sampling of loans that show discrepancies between bank DIAs and BSP DIAs.
- Review against loan files and electronic records of loan history (disbursement and payments)
- Classification of reasons for discrepancies for discussion with bank management

2. DETECTION OF UNREPORTED LOAN REFINANCING

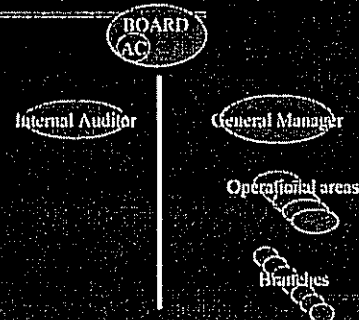
- Two loan listings: current loans and paid off loans
- Matching by client number and date of cancellation & disbursement (MS Access)
- Detection of “refinancing” (as opposed to “relending”)
 - “Recent” loans
 - Loans in arrears
- Summarization (by branch, loan officer) and discussion with management

3. INTERNAL CONTROL (Basle Committee objectives)

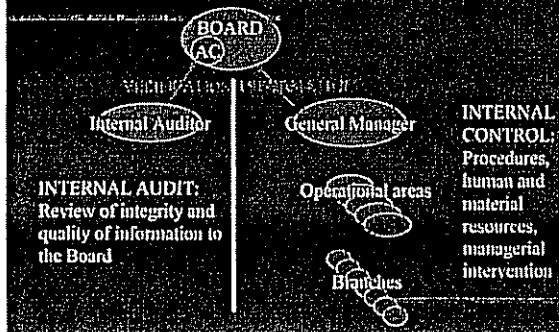
- Verify efficiency and efficacy of operations
- Assure reliability and completeness of financial information and management information
- Compliance with applicable laws and regulations

PAR, LLR, RL; CAR, DOSRI, LL; AL-GAP

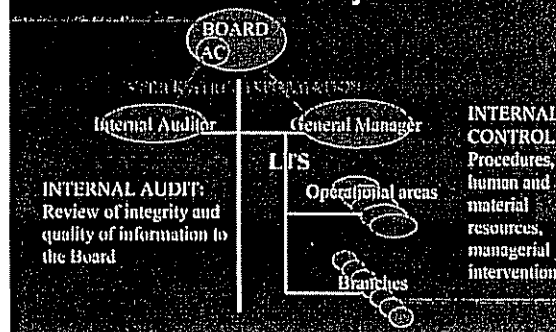
Organizational (governance and control) structure



Internal control is not internal audit



Role of information system



Loan tracking system

- Fundamental element of internal control
- Properly adapted to bank's operations and loan methodology (parameter blocks or audit leads)
- Up-to-date posting of transactions and daily reconciling with ledger balances
- Capable of tracking arrears and refinancings on a daily basis, by: individual loan (DIA), group or center, loan product, loan officer, branch
- Daily reports to managers and control officials and frequent monitoring by board or AC
- Adequate security (P&L), contingency plan

Adequate use of loan tracking system

- Internal control
 - Loan officer and loan committees: zoning; disbursement/monitoring/collection; relending and refinancing
 - Branch supervisor: productivity/quality targets
 - Head office manager(s): problem identification and prompt action (review of audit leads; data mining)
 - Board: monitoring and policy adjustment
- Internal audit
 - Verification of adequate performance of LTS
 - Verification of accuracy of reports to Board
 - Sampling for field verification (branches and clients); deterioration of lending practices; fraud

Frequent field presence by supervisors and managers

- Routine of unannounced visits to clients (environment of control)
- Prevention of:
 - Relaxation of lending practices (uncompliance with policies, irregular repayment schedules)
 - Fraud (unremitted collections; kickbacks; phantom clients)
 - Unauthorized or unreported loan refinancing

4. Sample size and sampling strategy

- Statistical (random) sampling at 90% confidence level and 5% margin of error:
 - 1.000 clients: sample is 212 clients
 - 5.000 clients: sample is 255 clients
 - 50.000 clients: sample is 268 clients
 - 100.000 clients: sample is 268 clients
- Man/days for 250 clients: about 12 (more than one week only in special cases)
- Applicable to: individual lending - homogeneous portfolio

Directed sampling criteria

- Simultaneous loans (Using ACCESS)
- Over and underperformers: branches, centers, loan officers (Using Pivot tables)
- Unreported refinancings
- Loans with irregular repayment schedules
- Sample size: about 250 clients
- Client interview: home/business; brief; fraud prevention – accuracy of records; family members ok, even colleagues/neighbors

Reduced sample size

- Only if strong internal audit that conducts scheduled routine visits to branches (twice a year) and clients (all loan officers)
- Use 90% confidence and 10% margin of error:
 - 1,000 clients: sample is 63 clients
 - 5,000 clients: sample is 66 clients
 - 50,000 clients: sample is 67 clients
 - 100,000 clients: sample is 67 clients

5. CAMELS

- No bias against microfinance
 - Not necessarily high risk or single type of loan (C,A)
 - Non interest expense may be very high (E)
- Emphasis in Management and good governance
 - Lack of adequate LTS (M=1)
 - Inadequate use of the LTS (M=1)
 - Lack of Board involvement (M=2)
 - Lack of fraud prevention mechanism (M=2)

Thanks; now.....

PRACTICAL WORK